Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of the Telecommunications Act of 1996	)	CC Docket No. 96-150
	)	
Accounting Safeguards Under the Telecommunications Act of 1996	)	

COMMENTS OF THE
AMERICAN PUBLIC COMMUNICATIONS COUNCIL

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August 26, 1996

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SUMMARY

The Commission must make significant changes to its Part 64 rules in order to satisfy the requirements of Section 276 of the Act. 47 U.S.C. § 276. First, the Commission's accounting rules must be sufficient not only to to prevent subsidies, pursuant to Section 276(a), but also to prevent any preferences or discrimination by a LEC in favor of its own payphone operations, pursuant to Section 276(b). These requirements to prevent subsidies and discrimination are unqualified; the Act does not allow the Commission to balance the need to prevent such abuses with concerns about efficiency. Elimination of subsidies and discrimination is particularly critical in the case of payphones because of the legacy of subsidies and inequality from years of fully integrated operation without any competitive safeguards.

As a critical step in preventing both discrimination and subsidization of LEC payphone operations, the Commission must require that all operational functions provided by a LEC to its own payphone operations must also be made available, and priced on the same basis, to IPP providers. These functions include network service, fraud protection, payphone and wire installation and maintenance, joint marketing, per-call tracking, billing, collection, and validation, and operator functions and/or commission payments for operator services. Accounting must ensure that if such services are offered to IPP providers at a price that is more than allocated cost, then the LEC's accounts must reflect that the LEC's payphone operations have been charged for this function at the same price. Alternatively, if the LEC wishes to provide tghe function to its own payphone operations on a cost allocated basis, then IPP providers must be offered the same function at a charge that is established on the same allocated-cost basis.

Current LEC cost manuals are severely deficient for purposes of evaluating the reasonableness of cost allocations and affiliate transactions. For example, they do not provide sufficient detail on allocation procedures and methodologies, allocation factors, amounts to which factors are applied, or the amounts allocated to nonregulated operations. Attestation audits are also inadequate at present. The Commission should require cost allocation manuals to supply far more detail, and should require auditors to provide more comprehensive attestations. Audits and workpapers should be available for public inspection.

Allocation methodologies also should be improved, to provide fairer standards for allocation of indirectly attributable and "unattributable" costs. The Commission should follow the example of numerous states and require a royalty fee to compensate ratepayers for the use of a LEC's company name and numerous other benefits to nonregulated operations such as payphone service from affiliation with the LEC.

Regarding affiliate transactions, transfer prices should be disclosed in detail in Cost Allocation Manuals and annual reports. Complete information regarding such transactions should be available for public inspection. If the Commission adopts its proposed change in the rule on valuation of transactions involving services, the Commission should provide that when services are provided by a carrier to an affiliate, the service is priced at the higher of prevailing market prices, fair market value, or fully distributed cost.

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The American Public Communications Council submits the following comments on the Commission's Notice of Proposed Rulemaking ("NPRM"), FCC 96-309, released on July 18, 1996. In this NPRM the Commission solicits comments on the accounting safeguards that should apply to Bell Operating Companies ("BOCs") and other incumbent local exchange companies ("LECs") in their provision of various competitive telecommunications and information services. APCC's comments focus primarily on accounting safeguards for payphone services that are necessary to implement Section 276 of the Act. 47 U.S.C. § 276.

STATEMENT OF INTEREST

APCC is a national trade association comprising over 1,200 manufacturers and providers of independent public payphones ("IPPs"). APCC's purpose is to promote fair competition and high standards of service in the payphone and public communications markets. APCC has actively participated in every major FCC proceeding affecting payphones.

I. SAFEGUARDS FOR INTEGRATED OPERATIONS

Section 276 of the Act requires the Commission to adopt safeguards to implement the requirements that a Bell Operating Company "(1) shall not subsidize its payphone service directly or indirectly from its telephone exchange service operations or its exchange access operations; and (2) shall not prefer or discriminate in favor of its payphone service." 47 U.S.C. Section 276(a). The safeguards must be, at a minimum, those adopted by the Commission in Computer III.[1] Id., Section 276(b)(1)(C).

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[1] Amendment of Sections 64.702 of the Commission's Rules and Regulations, (Computer III), CC Docket No. 85-229, Phase I, Report and Order , 104 FCC 2d 958 (1986) ("Phase I Order"), recon., 2 FCC Rcd 3035 (1987)("Phase I Reconsideration Order"), further recon., 3 FCC Rcd 1135 (1988) ("Phase I Further Reconsideration Order"), second further recon., 4 FCC Rcd 5927 (1989) ("Phase I Second Further Reconsideration Order"), Phase I Order and Phase I Reconsideration Order vacated sub nom., California v. FCC, 905 F.2d 1217 (9th Cir. 1990) ("California"); Phase II, 2 FCC Rcd 3072 (1987) ("Phase II Order"), recon., 3 FCC Rcd 1150 (1988) ("Phase II Reconsideration Order"), further recon., 4 FCC Rcd 5927 (1989) ("Phase II Further Reconsideration Order"), Phase II Order vacated sub nom., California v. FCC, 905 F.2d 1217 (9th Cir. 1990); Computer III Remand Proceeding, 5 FCC Rcd 7719 (1990) ("ONA Remand Order"), recon., 7 FCC Rcd 909 (1992), aff'd., California v. FCC, 4 F.3d 1505 (9th Cir. 1993), Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards, 6 FCC Rcd 7571 (1991) ("BOC Safeguards Order"), vacated in part and remanded, California v. FCC, 39 F.3d 919 (9th Cir. 1994) ("California"), cert. denied, 115 S.Ct. 1427 (1995).

The Commission tentatively concludes its current Part 64 rules, which were adopted in conjunction with[2] Computer III, provide sufficient safeguards to satisfy the subsidy prohibition of Section 276(a). Thus, the Commission tentatively concludes that it should only implement the minimum level of protection specified by Section 276(b)(1)(C).

APCC disagrees. There are several reasons why the existing Part 64 rules are not sufficient to satisfy Section 276 of the Act. First, the safeguards adopted by the Commission must not only be sufficient to prevent subsidies, pursuant to Section 276(a); they must also be sufficient to prevent any preferences or discrimination by a LEC in favor of its payphone service, as required by Section 276(b). The cost allocation rules of the Commission are not sufficient to satisfy this requirement of the 1996 Act.

Second, the Part 64 rules were adopted pursuant to Computer III, in which the Commission deliberately sought to balance efficiency concerns with concerns about subsidies and discrimination. Section 276(a) states unequivocally that Bell Companies "shall not subsidize" and "shall not discriminate". It does not say "shall not unreasonably subsidize" or "shall not unreasonably discriminate"; nor does it direct the Commission to balance subsidy and discrimination concerns with efficiency concerns, as was done in Computer II and Computer III. Section 276 simply directs the Commission to end subsidies and discrimination.

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[2] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Report and Order, CC Docket No. 86-111, 2 FCC Rcd 1298, (1987) ("Joint Cost Order"), recon., 3 FCC Rcd 6701 (1988), aff'd sub nom., Southwestern Bell Corp v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

Third, payphones have a much different history than enhanced services. At the time of Computer III, the Bell Companies were essentially new entrants into the enhanced services business. The Commission had determined that existing competitors were not meeting customer needs, and wanted to adopt regulations that did not place such an onerous burden on an arguably more efficient new competitor as to prevent it from even beginning to compete.[3] Phase I Order, 104 FCC 2d at 1007-10. The history of payphones is much different. The Bell Companies and other LECs have dominated the payphone industry for years, and their payphone operations have long benefited from obviously unequal interconnection and other forms of discrimination as well as acknowledged subsidies. In these circumstances, stronger measures are necessary to ensure that the legacy of inequality is removed.

Finally, the Act will place several additional lines of business into the "nonregulated" category. As such the opportunities and incentives for the BOCs and LECs to inappropriately shift costs or to act in an anticompetitive manner will increase, and the number of allocations and transactions that must be reviewed to prevent subsidies and

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[3] Similarly, when Computer II was implemented, the Bell Companies had transferred their existing customer premises equipment ("CPE") base to AT&T, and were starting out in the CPE market with essentially zero market share. Accordingly, the Commission was very concerned about not unduly burdening the Bell Companies' CPE operations. Even so, the Commission applied separate subsidiary requirements to the Bell companies for the first two years that the companies were subject to Computer II. Policy and Rules Concerning the Furnishing of Customer Premises Equipment, Enhanced Services and Cellular Communications Equipment by the Bell Operating Companies, Report and Order, 95 FCC 2d 1117 (1984) (subsequent history omitted).

discrimination will also increase. The Commission's resources will be stretched as never before.

Accordingly, the Commission must strengthen its cost allocation and affiliate transactions rules for the BOCs and other incumbent LECs,[4] in order to ensure that subsidies and discrimination are prevented. The rules need to be strengthened to prevent discrimination. APCC will comment on this in Section I.A. below.

In addition, the Commission must strengthen its Part 64 rules in order to ensure that LECs do not subsidize their own payphone operations. In particular, the Cost Allocation Manuals (CAM) of the BOCs and LECs should be significantly modified and enhanced, so that the FCC and interested parties can effectively review the affiliate transactions and regulated/nonregulated allocations. In addition, the enhancements addressed below will strengthen this Commission's and state commissions' oversight of cost allocations and affiliate transactions. The APCC's recommendations concerning CAM are set forth in Section I.B. below. In Section I.C., APCC addresses some issues regarding allocators. In Section I.D., APCC discusses the issue of requiring a royalty fee.

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[4] APCC believes that the accounting safeguards discussed herein should apply, at a minimum to all incumbent LECs with more than $100 million in annual revenues, as well as LECs serving island territories such as Puerto Rico and the Virgin Islands. See Comments and Reply Comments of the Georgia Public Communications Association ("GPCA"), filed July 1 and July 15, 1996, in CC Docket No. 96-128.

A. Accounting Must Reflect That Basic Operational Functions Provided By The LEC To Its Own Payphone Operations Are Made Available On The Same Terms To IPP Providers

The accounting safeguards that must be applied to LEC payphone operations are directly affected by the nondiscrimination requirement of Section 276(b) as well as by the nonsubsidization requirement of Section 276(a). For the reasons stated below, the imputed price of the operational functions provided by the LEC to its own payphone operations must be determined on the same basis as the price of the same functions when provided to IPP providers.

1. Section 276(b) Requires Non-Discriminatory Pricing

APCC contends that Section 276 of the Act requires that all operational functions that are made available by a LEC to its own payphone operation must also be made available to independent public payphone ("IPP") providers. A partial list of the functions that must be available on a nondiscriminatory basis was discussed in the Comments of the Georgia Public Communications Association in CC Docket No. 96-128.[5] These functions include: (1) network access lines, transmission and coin call processing services; (2) fraud protection, including screening and blocking services, provision of specialized telephone numbers, and limited liability associated with network

[5] In its own comments in CC Docket No. 96-128, APCC concurred in GPCA's comments. APCC does not know to what extent the issues raised herein will be addressed in this proceeding or in Docket No. 96-128. Therefore, APCC is here repeating some of the same arguments made in GPCA's comments.

service tariffs; (3) payphone and wire installation and maintenance; (4) joint marketing with network services, including operator services; (5) per-call tracking; (6) billing, collection, and validation; and (7) operator functions and/or commission payments for operator services. See Comments of the Georgia Public Communications Association in CC Docket No. 96-128, filed July 1, 1996, at 5-14.

These services and functions include not only the tariffed network services that payphone service providers require, but also non-tariffed functions that are currently either provided to IPP providers on a contract basis or not provided to IPP providers at all. For example, LECs may or may not make available network personnel to perform installation and maintenance functions on IPP provider's payphones and wiring.[6] However, under Section 276(b), it is clear that a LEC would be preferring or discriminating in favor of its own payphone operation if it used its installation and maintenance personnel to perform installation and maintenance on its own payphone operations but did not make its installation and maintenance personnel available to other PSPs under the same terms and conditions to perform installation and maintenance of their payphones and wire.

In order to ensure that these functions are available on the same terms and conditions to IPP providers as to the LEC's own payphone operations, the accounting safeguards must ensure that such functions are treated under one of two alternative

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6 Many LECs offer assistance to their residential and business customers, on a nonregulated basis, for installation and maintenance of customer premises equipment and inside wire. The same services may or may not be currently available from a LEC to IPP providers.

approaches. If such services are offered to IPP providers at a price that is more than allocated cost, then the LEC's accounts must reflect that the LEC's payphone operations have been charged for this function at the same price. Alternatively, if the LEC wishes to provide the function to its own payphone operations on a cost allocated basis, then IPP providers must be offered the same function at a charge that is established on the same allocated-cost basis.[7]

2. The Affiliate Transaction Rule Properly Applies to LEC Payphone Operations

Even if non-discriminatory pricing of LEC functions were not required by Section 276(b), such non-discrimination is required by the FCC's affiliate transaction rule to LEC payphone operations even if the payphone operations are not located in a separate affiliate. The Commission's rules provide that the affiliate transaction rule be applied in certain instances even though a LEC is not providing a nonregulated service through an affiliate:

> "The treatment of nonregulated activities shall differ depending on the extent of the common or joint use of assets and resources in the provision of both regulated and nonregulated products and services.
>
> (b) When a nonregulated activity does not involve the joint or common use of assets and resources in the provision of both regulated and nonregulated products and services, . . . [t]ransfers of assets, and sales of products and services between the regulated

[7] As discussed in GPCA's comments at __, whichever alternative is chosen, the imputed price to the LEC cannot reflect volume discounts which are not also available to reasonable aggregations of IPP providers.

activity and a non-regulated activity . . . shall be accounted for in accordance with the rules presented in § 32.27, Transactions with Affiliates."

47 CFR § 32.23.

APCC believes that the amount of common or joint use of assets and resources between a LEC's regulated network operations and its payphone operations are, or should be, sufficiently minimal that it is appropriate to require the application of the affiliate transaction rule whether or not the payphone operations are actually operated through an affiliate. The primary tangible assets of the payphone operation are the payphones themselves, as well as their associated enclosures, and these assets will be classified as entirely nonregulated.[8] Further, to the extent that the payphone operations rely on network services, those services will not be allocated but will be provided to the payphone operation on a tariffed basis.[9] Thus, there should be no joint and common use of assets except for, perhaps, some sharing of land and buildings and possibly vehicles. Moreover, given the overall size of Tier 1 LEC operations, even buildings and vehicles should not have to be used in common by regulated and nonregulated operations.[10] Sharing of assets

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8 Intangible assets such as location contracts and goodwill are the subject of a separate discussion. See GPCA Comments in CC Docket No. 96-128 at 14-17.

9 The Computer III rules, which are the minimum safeguards required under Section 276(b)(1)(C), require such treatement. See 47 CFR § 64.901(b)(1).

10 Cf. Joint Cost Reconsideration Order, 2 FCC Rcd at 6296 (application of affiliate transaction rule to certain transactions between regulated and nonregulated activities located in the same affiliate "is necessary to ensure that carriers do not seek to avoid our affiliate transaction rules by reincarnating a nonregulated affiliate as an operating division").

and resources should not be used as an artifice to create common and joint use to avoid the affiliate transaction rules.

Other sharing of resources should also be minimal. Payphone services are generally not provided in the same way as other network services: except for semi-public service, which must be removed from regulation under Section 276, there are no "subscribers" to LEC payphone services. Instead, the user of the service buys and pays for the service at the payphone. Thus, the resources used to market and provision payphones are generally quite different from the resources used to market and provision other LEC services. Further, unless the payphone operation is itself also providing operator services, payphone services generally do not utilize the same billing functions as other LEC services -- the billing is by means of coin collection. Accordingly, the Commission should rule that, under its existing policies, the affiliate transaction rule appropriately applies to LEC payphone operations.

3. In Any Event, APCC's Proposed Non-Discrimination Requirement Must Be Adopted To Prevent Subsidies

However, even if neither of the arguments in Sections I.A.1 and I.A.2. above were correct, in order to prevent subsidy, the Commission's rules still must provide that all the operating functions made available to LEC payphone operations must be available on the same terms and conditions to other PSPs. As discussed at the beginning of these comments, Section 276(a) is a flat prohibition against subsidization. The Commission is no longer permitted, if it ever was, to balance efficiency with subsidization concerns. And even if the Commission were permitted to take such a balancing approach, efficiency concerns should not outweigh subsidization prevention given the scope of the nonregulated activities that must be policed. A requirement that LEC functions be available to IPP provides on the same basis as they are provided to the LEC's own payphone operations providers critical assistance in preventing subsidies. Such a requirement ensures that, to the extent that misallocation of costs occurs, it will benefit the LECs' competitors as well as the LECs themselves. Thus, the existence of subsidization through cost misallocation will be more visible, and the incentive to misallocate costs will be substantially reduced.

B. Cost Allocation Manuals

1. Background

Part 64 rules governing cost allocations between regulated and nonregulated operations, were adopted by the Commission in FCC Docket No. 86-111. According to the Commission's Part 64 rules, costs are allocated according to a four-stage hierarchy: direct assignment, direct attribution, indirect attribution, and unattributable. Costs that are directly assignable include the costs of resources used exclusively to provide either regulated or nonregulated activities. These costs are directly assigned to the regulated or nonregulated operations. Costs that are directly attributable include the costs of resources used jointly to provide both regulated and nonregulated activities that can be apportioned using direct measures of cost causation, for example, the wages of a service order clerk who processes both regulated and nonregulated activities. Indirectly attributable are the costs of those resources used jointly to provide both regulated and nonregulated activities that use an indirect (surrogate) measure of cost causation in an effort to relate the costs to the final cost objective -- for example, the indirect supervision of the service order clerk.

Unattributable costs include the costs of resources shared between regulated and nonregulated activities for which no causal relationship can be easily identified -- for example, the salary of the chief executive officer. These costs are allocated using a general allocator comprised of previously assigned and attributed expenses.

Merely following the Commission's guidelines, however, does not guarantee appropriate treatment of costs. The Commission's rules leave areas of considerable discretion to the local exchange company. Moreover, as discussed below, the descriptions of cost allocation procedures provided in the CAMs are often so general that they place few meaningful limits on the ability of LECs to overallocate costs to the regulated operations and underallocate them to the nonregulated operations.

2. CAM Deficiencies

The BOC and LEC CAMs are severely deficient for purposes of evaluating the reasonableness of cost allocations and affiliate transactions. They do not provide a detailed description of the procedures or methodologies that are actually necessary for the companies' to adhere to the Part 32 and Part 64 requirements. Instead, the CAMs merely summarize the companies' policy interpretations of the Joint Cost Order. The allocation processes, time-reporting systems, accounting systems, and the like set up by the BOCs and LECs are complex and can only be audited with substantial effort. This problem can be exacerbated by claims of proprietary privilege, resulting in additional delays and imposing additional administrative burdens on regulators and other interested parties. Consequently, it is extremely difficult for this Commission or a state commission or other interested party to thoroughly evaluate the allocations and transactions between a company's regulated and nonregulated operations to ensure that ratepayers and competitors are being treated fairly.

Although there is more detail generally directed at the regulated/nonregulated cost allocations than there is on affiliate transactions, the cost allocation sections are not sufficiently detailed to permit meaningful review. They do not provide an auditable or objective standard against which to gauge compliance with either the CAM itself or the Joint Cost Order. The CAMs frequently do not specify the actual allocation factors used, the amounts to which the factors are applied, the allocation methodology, or the amounts allocated to the nonregulated operations.

The CAM sections on affiliate transactions often have virtually no detail. The CAMs may not identify affiliates of the BOCs and LECs that chain into the regulated operations. Furthermore, to the extent that the affiliates have transactions with the nonregulated operations of the BOCs or LECs, these affiliates are not necessarily identified. The CAM does not in many instances provide a description of the business activities of the affiliates. It only provides a listing of the types of transactions between the affiliates and the BOC and LEC. The CAM frequently does not provide the specific transfer pricing methodology employed for specific transactions. For each transaction the CAMs generally provide vague descriptions such as "negotiated contract," "prevailing market rates" or "Part 64.901 costing standards." These descriptions do not adequately describe the transfer pricing methods. Such vague descriptions preclude effective use of the CAM in evaluating the reasonableness of affiliate transaction pricing methods.

The attestation audits conducted by the BOC's outside independent auditors, which are one of the accounting safeguards, are supposed to provide assurance that a company's cost allocation and pricing techniques are fair and reasonable. But, these audits primarily attempt to verify that the company has followed the CAM, and as discussed above, the CAM is inadequate for purposes of determining what methods of allocation the company is actually using. In addition, the attestation audits are not truly independent or objective. These audits are oftenconducted by the same accounting firm that does a substantial amount of other work for the LECs. Thus, there can be an inherent bias in these audits. In many instances the language used in the audits is not conclusive. Oversights and judgments are not easily detected: they are often buried in mounds of audit workpapers, which are typically considered proprietary and therefore are not readily accessible.

3. Addressing the Deficiencies

The Commission can greatly enhance its own and others' ability to review cost allocations and affiliate transactions by improving the Cost Allocation Manual and imposing additional requirements for the annual attestation audits. Furthermore, these audits and workpapers should be available for public review.

Concerning the CAM, the Commission should require in addition to its current requirements, that the following items be specifically identified in the CAMs of the BOCs and LECs:

a. Cost Allocations

- The actual allocation factors used to allocate costs to each unregulated operation;
- The costs to which each allocation factor is applied;
- The amount allocated to each unregulated operation;
- For each subaccount, a detailed description of the allocation methodology employed;
- All internal and in-house policies and procedures used by the BOC and LEC for purposes of developing cost allocation factors and methods.

b. Affiliate Transactions

- All affiliates including those that directly assess charges to the BOC/LEC, those whose costs are chained into regulation, and those that provide products or services to the nonregulated operations of the BOC/LEC;
- Those non-regulated activities of the regulated company that are being treated as affiliate activities for purposes of the

affiliate transaction rulre because they do not involve substantial joint or common use of assets and resources (47 CFR § 32.23(b));

- The business activity of each affiliate;
- Detailed descriptions of the transfer pricing method used;
- If prevailing market price is used to price a service or product, the prevailing prices or studies undertaken to establish the price must be included in the CAM;
- The total amount charged between and among each affiliate and the BOC/LEC;
- All contracts for services and products sold between and among each affiliate and the BOC/LEC;
- All internal and in-house policies and procedures used by the BOC and LEC for purposes of developing transaction valuation factors and methods.

c. **<u>Concerning attestation audits, the Commission should require the following</u>**

- The auditor's report should attest to the adequacy of the Cost Allocation Manual in describing the manner in which costs have been allocated by the LEC;
- The auditor's report should attest as to the reasonableness, for purposes of preventing cross-subsidization, of pricing methods used to charge for transactions between the company and each of its nonregulated subsidiaries and affiliates;
- The auditor's report should attest as to the reasonableness, for purposes of preventing cross-subsidization of the cost allocation methods used by the BOCs and LECs to allocate costs between the regulated and nonregulated operations;
- The auditor's report should attest as to the reasonableness of any employee transfer arrangements and the identification

of all employee transfers between the regulated operations and nonregulated operations or affiliates;

- The audits and workpapers should be available for public inspection.

C. Allocation Methodology

APCC also believes that the Commission should reconsider the allocation methodology employed by the BOCs and LECs. Some of the allocation factors, such as the marketing allocator and general allocator used to allocate unattributable costs, are size-based, and thus allocate a large share of the costs to the regulated operation. This allocation is not necessarily reflective of the relative benefits received, nor of the costs incurred. Because the regulated telephone exchange and exchange access services of the BOCs and LECs are large in comparison to their nonregulated operations, the regulated operations are charged a large proportion of the costs allocated using these factors. Yet there is often no evidence that a company's regulated operations received a proportionate share of the benefit from the activities resulting in these charges.

For example, the services of a LEC's Chief Executive Officer, while undoubtedly necessary for the regulated operating company, are likely to be especially in demand as a means to coordinate all the various regulated and nonregulated activities of the company. It is reasonable to assume that the LEC's nonregulated operations may require a disproportionate share of the total executive time and attention.

In some instances, residual marketing expenses are allocated to the regulated and nonregulated operations on the basis of all previously assigned and attributed marketing expense. This allocator is often used to allocate generic advertising for the BOCs/LECs. Again due to the size differences between the regulated and nonregulated operations, a much larger share of the advertising costs are charged to the regulated operations. However, clearly, the substantial sums spent on advertising the Bell name provide a much greater proportional benefit to the nonregulated operations than the regulated operations. The size-based approach also ignores the reality that relatively new nonregulated operations benefit disproportionately from advertising and like expenses.

Because of the inherent problems associated with these two allocation factors, the Commission should require the use of a factor which gives 50% weight to the general and marketing allocation factors as they exist today, and 50% weight to a factor which allocated 50% of the cost to nonregulated operations and affiliates and 50% to regulated operations.

D. Royalty Fee

APCC believes the Commission should require LECs to assess a royalty fee on the nonregulated payphone operations and affiliates use of the LEC's name, reputation, and logo and to compensate the regulated operations for the benefits received by the nonregulated payphone operations and affiliates as a result of their association with the

LEC.[11] While the FCC has not required royalty fees in the past, state commission increasingly have recognized the value of a royalty fee mechanism as a means of preventing subsidization of nonregulated activities. See Attachment 1.

Such a mechanism is particularly appropriate for application to nonregulated payphone operations. Bell company payphone operations, for example, receive substantial benefits by being associated with the Bell company. These may include name recognition, a solid reputation, being associated with a financially strong and well entrenched firm, access to an experienced work force, proven methods of operations, and the Bell companies' proven technical expertise.

Use of the Bell name and affiliation with the Bell organization will allow the nonregulated payphone operations to avoid many of the costs faced by their competitors, such as establishing a name, reputation, a market presence, and obtaining qualified staff. In a competitive market, the nonregulated operations could only obtain these benefits at a substantial price. In the competitive market these advantages are extremely valuable and could mean the difference between a profitable business and no business at all. For example, in moving from a regulated to nonregulated environment, the Bell nonregulated operations and affiliates bring with them the substantial customer base obtained in a regulated environment. However, the LECs will have an incentive to confer all of these benefits on the nonregulated operations without compensation of ratepayers unless a

[11] The royalty fee as discussed herein includes elements of a franchise fee designed to compensate LECs for benefits that go beyond use of the company name. However, it would also be appropriate to require a franchise fee that is separate from the royalty fee.

royalty fee is imposed. As a result, prices charged to the LEC's customers will be higher than necessary and the LEC's nonregulated operations and affiliates will obtain advantages over their competitors.[12]

A royalty fee mechanism would ensure that the LEC's nonregulated operations and affiliates pay a fair market price for the intangible benefits they enjoy from being affiliated with the LECs. In the absence of a royalty, the LECs nonregulated operations and affiliates would be provided continued economic advantages, that have been financed by ratepayers, without paying fair compensation for them as would be necessary.

In addition to enhancing competition, a royalty fee will compensate ratepayers for the costs that they bore to build the intangible benefits associated with the Bell name and logo. Ratepayers have financed the costs to build this name recognition and image as well as the cost of training employees and building their level of expertise. When these benefits are transferred to the nonregulated operations and affiliates, the Commission should compensate the ratepayers for financing these past costs through a royalty fee mechanism.

Royalty fees have been assessed in a range from 2% to 5%. See Attachment 1. Franchise fees can also be used as a surrogate to estimate a reasonable royalty fee. Studies

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12 In a competitive market, by contrast, where there is a core business and a new venture, regulation is not required to compensate the core business for any intangible benefits it may bestow upon the new venture. Instead, competitive forces protect against inflated prices in the core market and unfair subsidization of the new venture. A competitive firm could not absorb the costs of transferring intangible benefits on its nonregulated operations and affiliates -- by failing to receive compensation for its fair value -- without incurring losses in its core business.

have been done which show that franchise fees as a percentage of revenue for the use of the logo, name and reputation, knowledge and expertise, and advertising and marketing support, range from 4% to 5% of sales revenue. See Direct Testimony of Dr. Douglas W. Elfner, before the Georgia Public Service Commission (on behalf of the [consumer advocate]), in Docket No. 4230-U, In re Investigation Regarding The Royalties for Intangible Benefits in Relation to Southern Bell Telephone & Telegraph Co., March 1993. But in addition to these continuing fees, franchisors also charge a one time fee that can be quite substantial. Thus, use of a 5% royalty fee would be conservative.

II. AFFILIATE TRANSACTIONS

The Commission has requested comment on whether, in implementing the 1996 Act's provisions regarding subsidization, it should amend the current affiliate transactions rules to incorporate certain of the modifications proposed in a recent notice of proposed rulemaking.[13] The APCC supports some of the Commission's modifications proposed in the Affiliate Transactions Notice, and recommends that these modifications apply to all affiliates, or other entitites subject to the affiliate transactions rule, that provide payphone service, even though an affiliate is not necessarily required for the provision of payphone service under Section 276.

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[13] Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions Between Carriers and Their Nonregulated Affiliates, Notice of Proposed Rullemaking, CC Docket No. 93-251, 8 FCC Rcd 8071, 8076, para. 9 (1993) ("Affiliate Transactions Notice").

A. <u>Generally Accepted Accounting Principles</u>

The Commission proposes to require affiliates to maintain their books and records in accordance with Generally Accepted Accounting Principles ("GAAP"). The Commission invites comments on whether requiring such accounting would assist it in fulfilling its statutory obligation to ensure that each affiliate will conduct all transactions with the LEC of which it is an affiliate on arm's length basis. NPRM, ¶ 68. While APCC supports the Commission's preliminary decision to require affiliates to use GAAP in preparing their books and records, this will not necessarily "ensure that each affiliate will conduct all transactions with the BOC on an arm's length basis." It will, nevertheless, assist the Commission and other interested parties in evaluating if the transactions are conducted on an arm's length basis, by ensuring that the LECs' books and records are kept in a manner consistent with GAAP.

B. <u>Additional Requirements</u>

The Commission also requests comments on whether it is necessary to adopt any additional accounting, bookkeeping, or record keeping requirements for affiliates and if so what those requirements should be. APCC recommends that the Commission also require affiliates that transact directly or indirectly (through chaining) to document any transfer price between and among affiliates and the LECs, and that this documentation be a required component of the LECs' Cost Allocation Manual. This should not impose an unnecessary burden on the LECs as the documentation should be maintained by the affiliate for purposes of providing the information to auditors for attestation audits. Such a